



Division of Supervision & Consumer Protection 500 West Monroe, Suite 3500, Chicago, IL 60661 312-382-7500

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Regulation R - Bank and Trust Department Securities Activities under the Gramm-Leach-Bliley Act of 1999 (GLBA)

After several years of development, with input from the regulatory agencies and the financial services industry, the Securities and Exchange Commission (SEC) and the Federal Reserve Board (FRB) have issued the final version of Regulation R (formerly referred to as proposed SEC Regulation B). Prior to the passage of GLBA, banks had a blanket exemption from broker registration. In place of the blanket exemption, GLBA and Regulation R delineate exceptions by which a bank may engage in certain types of securities-related transactions without being required to register as a broker with the SEC. In order to provide banks time to make necessary changes to their recordkeeping systems and compliance programs, banks are exempt from complying with Regulation R until the first day of their first fiscal year starting after September 30, 2008; for most institutions, this will mean a compliance date of January 1, 2009. It is anticipated that each federal banking agency will adopt recordkeeping rules to assist in this process.

While bank management should be familiar with the entire regulation, specifically as it relates to the types of securities-related services the bank offers, the following exemptions may be most applicable for community banks:

TRUST & FIDUCIARY ACTIVITIES EXCEPTION: Banks that effect securities transactions in a trustee or fiduciary capacity are exempt from registration, provided they are “chiefly compensated” for those transactions on the basis of specifically enumerated types of “relationship compensation.” The rules establish a test to determine how a bank is “chiefly compensated,” and the bank is permitted to choose either an account-by-account (Rule 721) or a bank-wide (Rule 722) approach. “Relationship compensation” consists of the following: 1) an administration or annual fee, 2) revenues based on a percentage of assets under management, 3) a flat or capped processing fee that does not exceed the cost the bank incurs in executing such securities transactions, or 4) any combination of such fees. Management will be expected to maintain adequate documentation to support its internal “chiefly compensated” calculation. The account-by-account and bank-wide alternatives both use a two-year rolling average comparison. For institutions using the bank-wide approach, “relationship compensation” must be at least 70 percent of total fiduciary compensation. For institutions using the account-by-account approach, “relationship compensation” must exceed 50 percent of total compensation for each account.

SAFEKEEPING & CUSTODY EXCEPTION: Banks can continue to perform duties and services in connection with safekeeping and custody arrangements. Regulation R provides two exemptions under which banks can continue to accept orders for securities transactions from customers. One exemption applies to orders for securities transactions that are received from employee benefit accounts, IRAs, and similar accounts. Another exemption is provided for accepting orders from other custody customers on an accommodation basis.

For employee benefit, IRA and similar accounts, the bank may accept orders if: (1) the bank does not advertise order taking; (2) no bank employee is compensated based on whether or not a securities transaction is executed or on the quantity, price or type of the security; (3) the bank is not a trustee or a fiduciary other than a directed trustee; (4) the bank is not a carrying broker; and (5) the bank complies with the Regulation's trade execution requirement. When a third party bank is an employee benefit and/or IRA custodian, a bank that acts as non-fiduciary administrator/recordkeeper may rely on the exemption if (1) both the custodian bank and the administrator/recordkeeper bank comply with the exemption, and (2) the administrator/recordkeeper bank does not execute cross trades other than those specified in the Regulation.

For all other accounts, a bank may accept orders only as an accommodation to the customer if: (1) any fee charged does not vary based on whether or not the order is accepted or on the quantity or price of the security; (2) advertisements and sales literature do not state that the bank accepts orders except as part of describing other aspects of its custodial services; (3) the bank does not provide investment advice or research, make recommendations, or solicit transactions; and (4) the bank complies with the trade execution and compensation requirements that apply to employee benefit, IRA and similar accounts.

NETWORKING EXCEPTION: Non-licensed bank employees may receive compensation for referring customers to a broker-dealer. However, any referral fee paid by the bank to a non-licensed employee must be a "nominal," one time cash payment of a fixed amount. Referral fees cannot be contingent on whether a customer purchases securities. Contingent fees of greater than a nominal amount can be paid for referrals of high net worth and institutional customers, provided that the bank and broker-dealer satisfy certain requirements designed to protect customers from inappropriate referral activities. Note that non-licensed bank employees may not make general or specific investment recommendations regarding securities, qualify a customer as eligible to purchase securities, or accept orders for securities. They may, however, perform duties that are solely clerical or ministerial in nature. Refer to Rules 700 and 701 for a complete discussion of the definitions that are critical to implementation of the networking exception.

SWEEP ACCOUNTS & TRANSACTIONS IN MONEY MARKET FUNDS EXCEPTION: Banks can sweep deposits into no-load money market funds. If a bank chooses to sweep to a load fund, the bank must provide the customer with a prospectus showing the fund's fees, and may not characterize the funds as no-load.

DE MINIMIS EXCEPTION: Banks may execute up to 500 securities transactions per year in all departments for their own account and for customers. Securities transactions executed through dual employees are considered to be transactions of the networking broker-dealer, and therefore are never included in calculating the 500 transaction limit.

Banks are urged to review the complete text of Regulation R to plan for program compliance. For further details, refer to Financial Institutions Letter FIL-92-2007 which can be accessed on the FDIC's website: <http://www.fdic.gov/news/news/financial/2007/fil07092.html>.

Financial institutions whose primary federal regulator is not the FDIC should contact their primary federal regulator for its requirements. If you have any questions concerning this information, please contact us by e-mail at scans@fdic.gov or call us at the Chicago Regional Office Banker Hotline, (312) 382-6926.